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DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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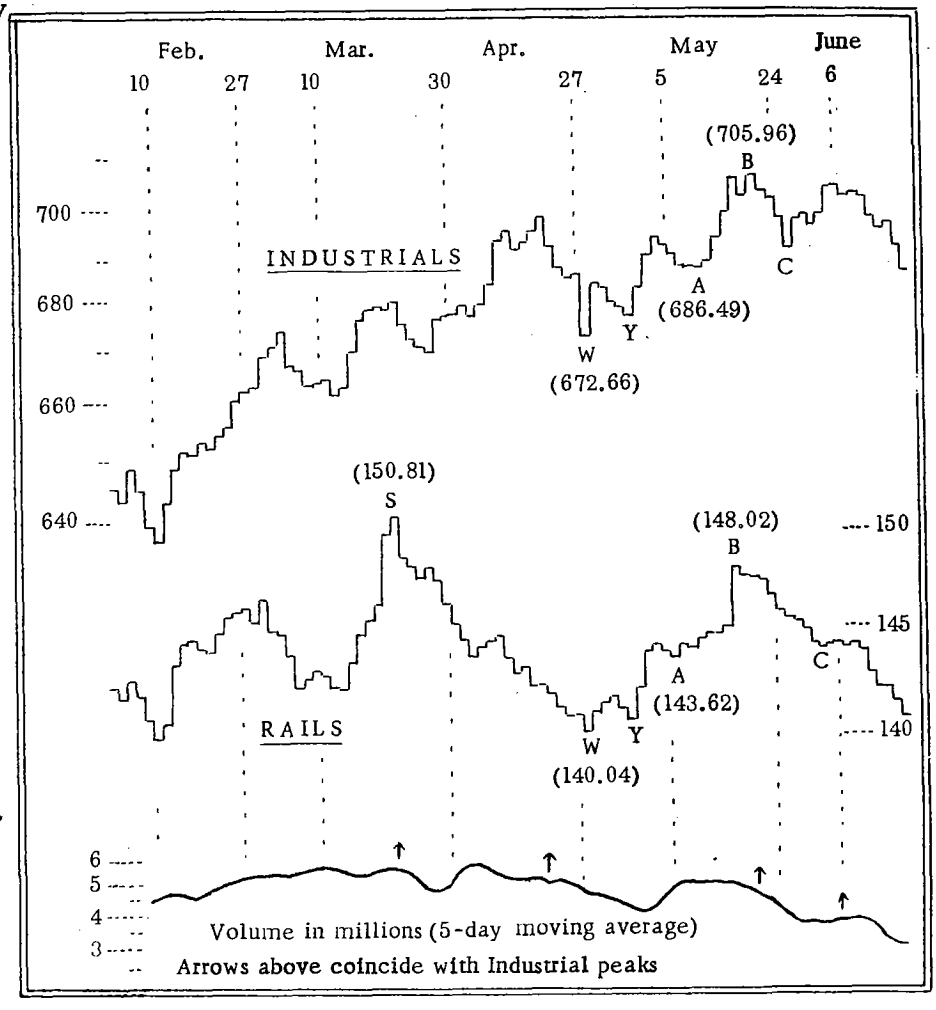
Dow, Hamilton and Rhea always stressed the basic principle of "values" as applied to stock prices. I have talked increasingly about values in recent Letters in an attempt to put the current market into perspective. Letter 143 included a chart of the yields on the D-J Industrial Average, and the thought was expressed that when the average yield on the Industrial Average drops under 3 1/2% the market may well go higher, but that at such times stocks are a speculation, not an investment.

"Prices are controlled by values in the long run," wrote Dow. He might have added that the intangible factor which causes stocks to sell above or below values is confidence or the lack of confidence (fear). Six months ago confidence in the Kennedy administration was running high. Developments during and since "the first 100 days" have brought more sobering appraisals, however. If the attitude of the "money-majority" is now changing from enthusiasm to doubt, that change in sentiment is sure to be reflected in the average price of stocks on the N. Y. Stock Exchange.

THE MARKET Much has been written about the troubles of the railroads, but their chief trouble is published each week under the column marked "carloadings". Rail carloadings have had their normal seasonal rise this year, but so far carloadings have fallen consistently behind the 1959 and 1960 figures. Manufactured goods can go to either of two places: (1) they can go into inventory, or (2) they can "hit the road" via the rails, trucks and airlines. Judging from the action of the Industrial Average (and the F.R.B. Index of Production) goods are now being turned out at a reasonable "clip", but judging from the action of the Rail Average there is a real question about the disposition of those goods. If actual sales and transportation of goods are to expand over the foreseeable future, that expansion should be reflected in higher rail carloadings, profits and prices for rail stocks.

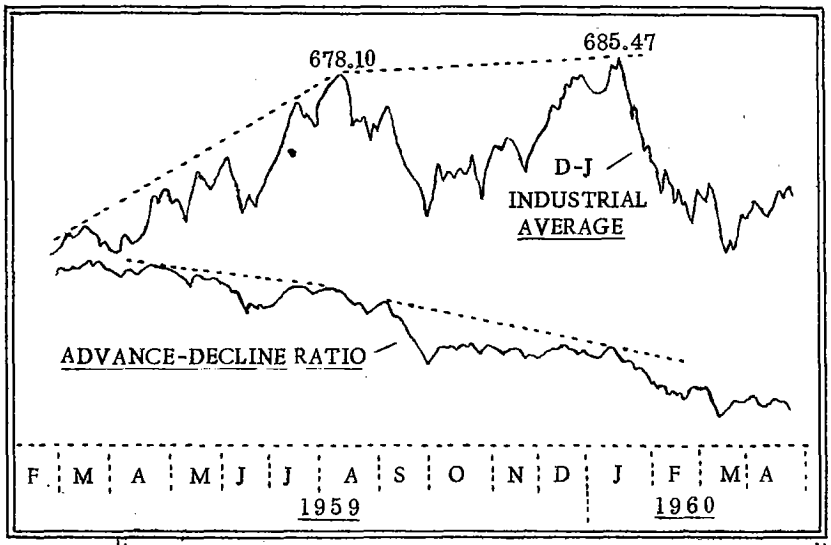


In view of all this, the action of the Rail Average has been discouraging. On June 9 the carrier average broke below its preceding decline low at A (143.62 - see chart).

On June 16 (Friday) Industrials confirmed by violating their own corresponding point at A (686.49). Volume expanded slightly on the Industrial penetration but held well under 4 million shares. Nevertheless, for the first time on the entire advance

since October, 1960, preceding decline lows have been broken by both Averages.

Under the "continuing trend principle", the primary trend must be taken to remain bullis The secondary trend has probably turned down. A joint penetration of the W points (Indust. 672.66, Rails 140.04) would provide conclusive proof that the secondary trend has turned bearish. Friday's joint violation of the A points means that recent stock acquisitions should have been "pruned" if not eliminated. Certainly, if the W points are broken none but the very strongest stocks should be retained.



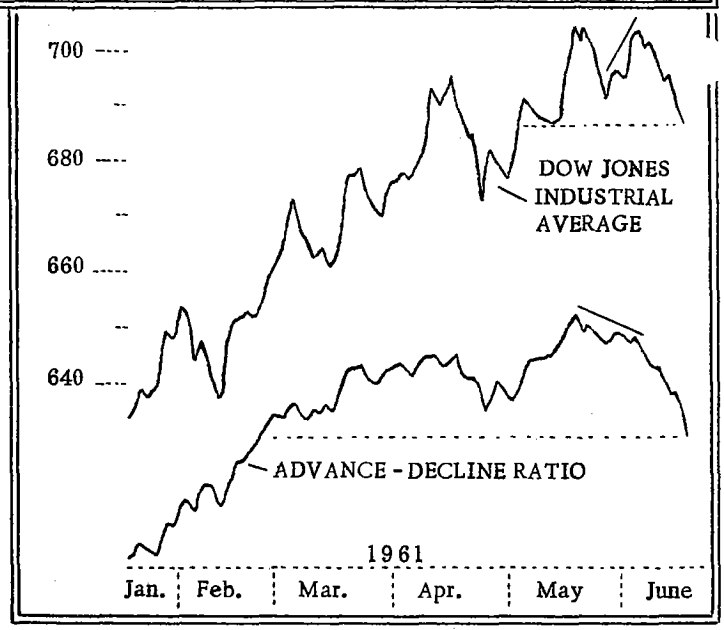
THE ADVANCE-DECLINE RATIO (A-D Ratio)

In the final analysis stocks do only two things (1) They rise or fall in price. (2) They expand or contract their trading volume. Each day the average price of the stocks comprising the leading Averages together with the volume of trading are computed by Dow Jones & Co. Dow's Theory attempts to draw inferences from these statistics, such inferences being based on case histories which extend back to 1896.

Over the years a number of additional statistics and indicators have appeared, and these too can often be of great help to market students. One of the indicators which I have found particularly useful is the ratio of total advances to declines, commonly known as the "breadth" of the market or the advance-decline ratio. The construction of the A-D Ratio was last described in Letter 141 (extra copies of that Letter will be sent on request -- please send stamped self-addressed envelope).

The A-D Ratio measures the advancing or declining tendencies of all stocks traded on the N. Y. Stock Exchange. If more stocks rise than fall the A-D Ratio advances; if more stocks fall than rise the Ratio declines. In a healthy bull movement the A-D Ratio tends to work steadily higher, thus confirming the rising trend in the D-J Industrial Average.

One remarkable characteristic of almost every major "top" in the Averages since the 1920's is that each has been preceded by at least a few weeks (often more) of declining "breadth". For this reason, I believe that all periods of divergent action between breadth and price (Industrial Average advancing while the A-D Ratio retreats) are worth studying.



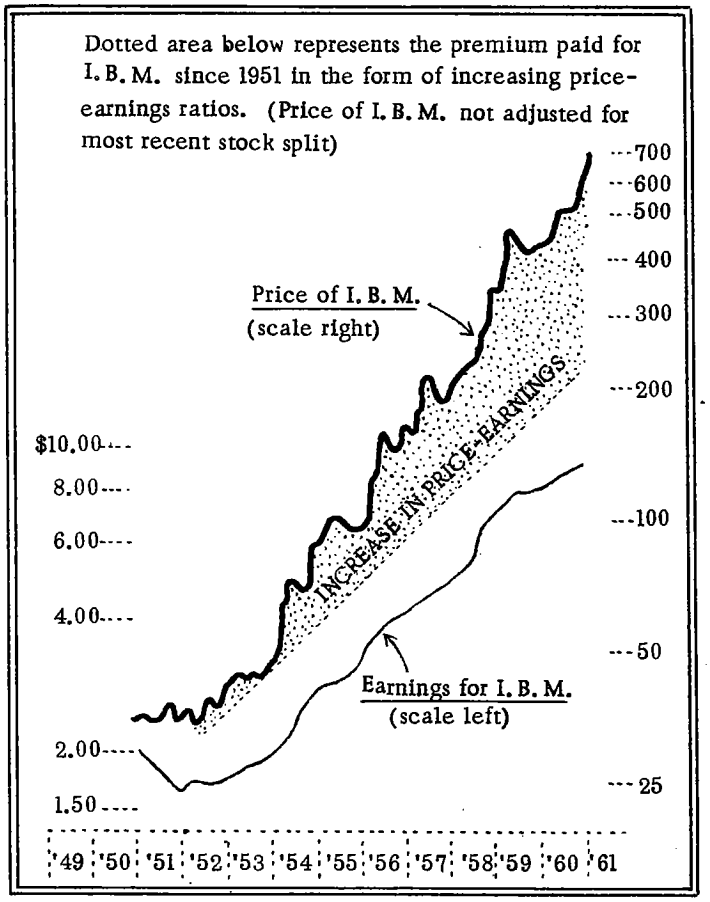
To review a bit of recent history, the accompanying chart shows the dangerous situation which existed during the 1959-60 period. Here we see the initial reversal of the A-D Ratio in April, 1959, then the long steady decline of the Ratio during 1959 and most of 1960. Obviously, what was happening during that period was that the general market was sinking despite the fact that the D-J Industrial Average advanced to historic peaks in August, 1959 (678.10) and January, 1960 (685.47). The trouble became apparent in the first quarter of 1960 when the D-J Industrials dropped precipitously, thus filling the "vacuum" which had been created by the steadily declining A-D Ratio.

Referring to the current situation, on May 17 the A-D Ratio reached a high for the entire advance since (October, 1960 (see current chart). Two days later, on May 19, the Industrial Average touched an all-time high of 705.96. As seen on the chart, however, a minor divergence occurred when the A-D Ratio retreated from its May 17 peak as Industrials rose to their record high.

Following a shart period of general market weakness (May 19 to 25), the Industrial Average again rallied, and on June 6 (see chart) Industrials advanced to within 3 points of their previous all-time high. But here the divergent action of the A-D Ratio was even more striking. By June 6 (despite the impressive Industrial performance) the A-D Ratio had retreated to the level of early May. Last Friday (June 16) saw the Industrial Average retreat to 685, but by this time the A-D Ratio had dropped to the level of February 23 (at which time the Industrial Average was 654). In other words, since mid-May the Industrial Average has acted considerably better than the great mass of stocks on the N.Y. Stock Exchange. The conclusion -- either "breadth" must improve or the market is in for trouble ahead.

INFLATION One of the commonest arguments in favor of a continuation of the bull market is the presumption of continuing inflation. Yet except for periodic interruptions (usually during bear markets), inflation has been with us since the inception of the nation. History also records a number of periods during which stock prices retreated or remained static despite (1) continuing inflation and (2) a trend of rising earnings.

Perhaps the most remarkable recent example of this was the period between 1946 and 1949. The 1946-49 era was characterized by the usual inflation; moreover, during those four years the earnings on the D-J Industrial Average progressed as follows: 1946 - $13.63, 1947 - $18.80, 1948 - $23.07, 1949 - $23.54. In 1946 the Industrials touched a peak of 212.50; by 1949 they had dropped to 161.60. During the period of 1946-49, despite expanding earnings, Industrials never bettered the 1946 peak of 212.50. What is to be learned by this strange sequence of events?



Obviously, there must be more to a bull market than inflation and rising earnings, both of which were much in evidence during the period in question. The "hidden ingredient", as the advertising men put it, is confidence. Without increasing confidence there can be no rise in price-earnings ratios and no bull market. Throughout most of the 1946-49 period the public remained apathetic and even frightened. Talk during the late '40's centered about the imminence of the "coming post-war depression".

I have included a chart of the great "growth stock", I.B.M., to illustrate the confidence (or increasing price-earnings ratio) principle. Back in 1951 I.B.M. was selling for about $34.00 with earnings of around $1.70. This meant that investors were willing to pay about 20 times earnings for I.B.M. in those days, and this was considered a generous price. By the end of 1960 I.B.M. was earning almost $9.00 and was selling for over $700.00. Investors in 1960 were willing to pay almost 80 times earnings for I.B.M. In other words, the big "kicker" behind I.B.M.'s price explosion was the expanding price-earnings ratio, even though earnings had also fared remarkably well. Note the increasing span between the earnings on I.B.M. and the price (dotted area on chart). If I.B.M. were now quoted on the basis of its 1951 price-earnings ratio, the stock would sell at about a quarter of its present price or around 180.

The conclusion, then, is that increasing confidence (and an increasing willingness by investors to discount future possibilities) is often the force behind a dynamic rise. In major bear markets the gears are reversed. Then, not only do earnings decrease but price-earnings decrease. And because of the latter, even those few stocks which actually do increase earnings during bear markets are very liable to suffer, since price- earnings ratios in general are declining along with confidence.

CORRECTIONS (with apologies) Letter 145, page 1. Mr. Eliot Janeway, the well-known economist, called to tell me that the new deficit in the Federal budget will not come from President Kennedy's spending programs but from disappointing corporate and individual tax returns. "The money just ain't going to be there," says Mr. J. As far as "New Frontier" spending is concerned, he warns that much of it may be financed through higher taxes. Janeway's estimate for the budget deficit in the next fiscal year -- a "whopping" 12 billion dollars (we'll probably all have "aching backs" at that rate).

CORRECTIONS continued Letter 146 -- (chart on page 1) point A on Industrials should read 686.49 (not 686.05). Page 2 (third paragraph) W point on Rails should read 140.04 (not 144.04). Page 2 (last paragraph) previous peak on Confidence Index should read September, 1959 (not September, 1960).

STOCKS Of the 15 stocks in our "continuing-study list", 5 are now under their 30-week moving average (M.A.). These are Int. Paper (M.A. 32 7/8), Eastman Kodak (see below), G.E. (M.A. 67 3/4), U.S. Steel (M.A. 83 5/8) and N.Y. Central (M.A. 18). This is the highest number of key stocks under their M.A. in many months.

Eastman Kodak (EK) has been a rather "tired" actor this year. The chart shows the initial rise by EK out of its October, 1960 base. From the February, 1961 low of 104 1/4, EK finally rallied above its M.A. to a high of 120. Without developing any real upside momentum. EK held above its M.A. for 11 consecutive weeks -- then in May it dropped below its M.A. again. I consider EK to be trendless as long as it fluctuates between the February low of 104 1/4 and its M.A. which is now 112.

Alcoa -- still bullish (M.A. 72 1/2), but short interest has declined for 5 consecutive months. Would hold as long as stock closes above 70.

Gen. Elect. Two weeks ago GE rose to exactly its M.A. -- then turned down. Would hold unless it closes under 60.

As shown on chart (chart courtesy of Traders Research, 6185 Lambert Airport, Mo.), N.Y. Central has formed a "head-and-shoulders" reversal pattern and now appears to be in trouble. My guess is that CN's October, 1960 low of 14 3/4 will be "tested" again. Central is now tending to hold under its M.A. which this week rose to 18.

(Written - Monday, June 19th - 1 P.M.)